Economic Outlook

2/17/87 84750-2

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research & Planning Division

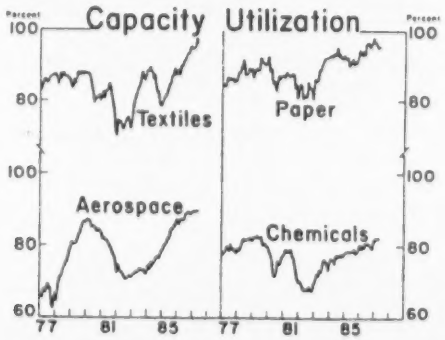
August 1987

The U.S. economy has been successfully transformed from an economy driven by strong domestic demand to one in which a major impetus comes from improvement in trade. The following table chronicles the transition. Between mid-1984 and mid-1986, strong increases in domestic demand were offset by widening trade deficits. Real GNP growth averaged 2.9% per annum during that period. The transition began in the second half of last year, when the non-oil trade deficit bottomed out, though the rise in oil imports continued to detract from growth. With weakened domestic demand and little improvement in trade, economic growth dropped to 1.5% in the second half of 1986. In the first half of this year, the long-awaited improvement in trade finally began, and a narrowing trade deficit added 1.3% to economic growth. Although the growth in domestic demand remained moderate, the improvement in trade lifted overall economic growth in the first half of this year to 3.5%.

Contribution to Real GNP Growth
(Seasonally Adjusted Annual Rates)

	1984 II-1986 II	1986 II-1986 IV	1986 IV-1987 II
Domestic Demand	3.8%	1.8%	2.2%
External Demand	-0.9	-0.3	1.3
Non-oil	-0.8	0.0	1.0
Oil Imports	-0.1	-0.3	0.3
Real GNP Growth	2.9%	1.5%	3.5%

The effect of trade improvement is not only evident in macroeconomic statistics but is also visible in the performances of individual industries. In general, industries that are export-oriented or face strong foreign competition have fared the best. Some of them have even run into capacity constraints. As the following chart shows, operating rates in the textile, paper, aerospace and chemical industries, all heavily trade-oriented, have surpassed their previous cyclical peaks and are approaching full capacity.



This growth pattern of trade improvement supplemented by moderate increases in domestic demand is expected to continue. It took a long time for dollar depreciation to turn the trade balance around. But now that U.S. industries have regained their international competitiveness, the improvement in trade should be long-lasting. This trade improvement, however, will not be able to carry

the economy forward by itself. It has to be supplemented by at least moderate growth in domestic demand.

Because most of the increases in domestic demand in the first half of this year came from inventory building, there has been a lot of concern about whether even moderate growth in domestic demand can be maintained in the second half of this year when inventory investment declines. It is our view that the reduction in inventory investment will be moderate, and the weakness in inventory investment will likely be more than offset by an acceleration in domestic final sales. The inventory to sales ratio has indeed risen from the extremely low end-1986 level, but it remains moderate by historical standards. In addition, the recent increases in manufacturers' inventories were concentrated in materials and supplies, while finished goods inventories were reduced. This indicates that the inventory increases were a reaction to the recent sharp rise in commodity prices rather than an involuntary buildup of unsold goods. The extremely weak domestic sales in the first half of this year largely reflected the slump in sales in the first quarter resulting from tax reform. Both consumer and business spending rebounded in the second quarter and, judging by the recent sharp increases in new factory orders, will likely continue to grow.

Victor Kung

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual				Forecast				Actual	Forecast	
	1986		1987		1987		1988		1985-	1986-	1987-
	III	IV	I	II	III	IV	I	II	1986	1987	1988
Consumer Spending	4.7	0.3	-0.5	1.4	1.7	1.8	1.3	1.3	2.7	1.3	1.4
Business Investment	-0.4	0.6	-1.9	0.9	0.6	0.6	0.6	0.5	-0.3	-0.2	0.6
Residential Investment	0.5	0.1	-0.4	0.0	-0.1	-0.2	-0.1	0.2	0.6	0.0	0.0
Change in Inventories*	-3.1	-0.1	4.4	-1.5	-0.8	-0.1	0.1	0.2	0.0	0.3	-0.3
Net Exports	-1.6	1.1	1.8	0.8	0.8	1.0	0.8	0.7	-1.0	0.6	0.7
Government Purchases*	1.3	-0.5	1.0	1.0	0.9	0.7	0.5	0.5	0.9	0.7	0.8
Real GNP	1.4	1.5	4.4	2.6	3.1	3.8	3.2	3.4	2.9	2.7	3.2

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual				Forecast				Actual	Forecast	
	1986		1987		1987		1988		1985-	1986-	1987-
	III	IV	I	II	III	IV	I	II	1986	1987	1988
Nominal GNP	5.3	2.1	8.6	6.7	7.4	8.6	8.4	8.9	5.6	6.1	8.4
GNP Deflator	3.6	0.7	4.2	3.8	4.1	4.6	4.9	5.4	2.6	3.3	5.0
Corporate Profits After Tax#	0.4	-0.3	6.7	13.5F	8.7	7.4	13.2	6.7	-1.0	9.1	7.7

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	Apr.	May	Jun.	1986	1987	1988
Consumer Price Index** (%)	0.4	0.3	0.4	1.1	5.3	6.1
Industrial Production (%)	0.0	0.5	0.2	1.0	3.0	3.9
Retail Sales (%)	0.3	-0.3	0.4	5.5	3.6	4.2
Auto Sales (million units, a.r.)	10.5	9.8	10.1	11.5	10.1	10.0
Housing Starts (million units, a.r.)	1.64	1.60	1.59	1.81	1.66	1.61
Unemployment Rate (%)	6.3	6.3	6.1	7.0	6.3	5.7
Merchandise Trade Deficit ($ bn., a.r.)	-159.6	-172.8	n.a.	-166.3	-155.0	-135.0

*Adjusted for CCC purchases. **Annual percent changes are December to December.
#Quarterly data are year-over-year percent changes.
a.r.=annual rate F=Forecast